



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

November 8, 2004

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL  
MANAGEMENT AND COMPTROLLER)

SUBJECT: Independent Auditor's Report on the Fiscal Year 2004 Department of the  
Navy General Fund Financial Statements (Report No. D-2005-013)

The Chief Financial Officers Act of 1990, as amended, requires the Inspector General of the Department of Defense to audit the accompanying Department of the Navy General Fund Consolidated Balance Sheet as of September 30, 2004 and 2003; the related Consolidated Statement of Net Cost; the Consolidated Statement of Changes in Net Position; the Combined Statement of Budgetary Resources; and the Combined Statement of Financing for the fiscal years then ended. The financial statements are the responsibility of the Department of the Navy management. The Department of the Navy is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to give an opinion on the Fiscal Year 2004 financial statements of the Department of the Navy General Fund because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance With Laws and Regulations. The Report on Internal Control and Compliance With Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of the audit.

**Disclaimer of Opinion on the Financial Statements**

The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that material deficiencies in the Department of the Navy financial statements still exist. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Inspector General of the Department of Defense to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. The Department of the Navy has also acknowledged, and prior audits have identified, the material weaknesses listed in the Summary of Internal Control. These material weaknesses also affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the principal financial statements.<sup>1</sup> As described above, we are unable to express, and we do not express, an opinion on the financial statements and the accompanying information.

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<sup>1</sup> The annual financial statements include the principal financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

## Summary of Internal Control

In planning our audit, we considered the Department of the Navy's internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance. However, previously identified reportable conditions,<sup>2</sup> all of which are material, continued to exist in the following areas:

- Accounting and Financial Management Systems;
- Fund Balance with Treasury;
- Accounts Receivable;
- Inventory and Related Property;
- General Property, Plant, and Equipment;
- Accounts Payable;
- Environmental Liabilities; and
- Problem Disbursements.

A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance that are material in relation to the financial statements would be prevented or detected on a timely basis. Our internal control work would not necessarily disclose all material weaknesses. See the Attachment for additional details on material internal control weaknesses.

## Summary of Compliance With Laws and Regulations

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited because management acknowledged, and prior audits confirm, that instances of noncompliance continue to exist. The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us that critical financial management and feeder systems do not comply with Federal financial systems requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level, as required under the Federal Financial Management Improvement Act (FFMIA) of 1996. Therefore, we did not determine whether the Department of the Navy was in compliance with all applicable laws and regulations related to financial reporting. See the Attachment for additional details on compliance with laws and regulations.

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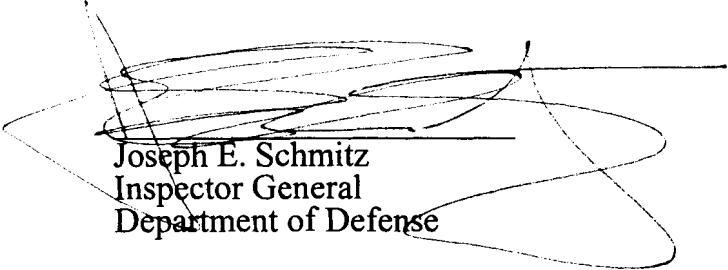
<sup>2</sup> Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

*A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time. —Constitution of the United States, Article I, Section 9*

## Management Responsibility

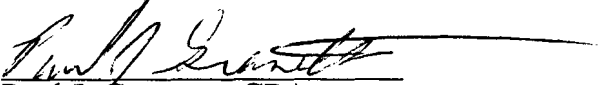
Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles,
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met, and
- complying with applicable laws and regulations.



Joseph E. Schmitz  
Inspector General  
Department of Defense

Attachment:  
As stated



Paul J. Granetto, CPA  
Assistant Inspector General  
Defense Financial Auditing Service

## **Report on Internal Control and Compliance With Laws and Regulations**

### **Internal Control**

Management is responsible for implementing effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly and that assets are safeguarded against misappropriation and abuse. The purpose was not to, and we do not, express an opinion on internal control over financial reporting because management acknowledged that previously identified reportable conditions, all of which are material, continue to exist. The following financial management deficiencies are indications of material weaknesses in internal control that may adversely affect any decision by the Department of the Navy that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Financial information reported by the Department of the Navy also may contain misstatements resulting from these deficiencies.

**Accounting and Financial Management Systems.** The Department of the Navy financial systems deficiencies include the inability to implement elements of Generally Accepted Accounting Principles (GAAP), and inadequately implement the U.S. Government Standard General Ledger. Also, adjusting entries were needed to correct errors caused by differences between accounting systems.

**Fund Balance with Treasury.** Inaccurate or missing fund accounting codes have resulted in unmatched disbursements and collections; the use of suspense and budget clearing accounts; deposits-in transit; check discrepancies; undistributed disbursements, collections, and abnormal balances; and an inability to reconcile the Department of the Navy records with the Department of the Treasury records.

**Accounts Receivable.** Intragovernmental accounts receivable may be overstated because of outstanding over aged reimbursable work orders. Seller side trading partner data are neither captured nor maintained at a transaction level detail, or may be missing or incomplete because of system deficiencies. Accounts receivable balances with the public may not be complete or accurate because of system and procedural problems. An inadequate audit trail exists because of unmatched and undistributed collections being posted to accounts receivable at a summary level based on percentages.

**Inventory and Related Property.** The legacy systems currently being used do not maintain the historical cost data necessary to comply with Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and Related Property." In addition, completeness issues exist because these legacy systems were not designed to ensure that all of the inventory items are included in the values reported on the Balance Sheet. Also, some commands have not used the consumption method for expensing Operating Materials and Supplies (OM&S). Some commands are unable to report OM&S at the detailed transaction level and only maintain beginning and ending balances.

**General Property, Plant, and Equipment.** Completeness issues associated with recognizing internal use software and leasehold improvements still exist. Trading partner data for capitalizing assets may not always be recorded. Statement of Federal Financial Accounting Standards No. 23, "Eliminating the Category National Defense Property Plant and Equipment," has not been fully implemented.

**Accounts Payable.** Intragovernmental accounts payable such as MILSTRIP, fuel payables, and non-PowerTrack transportation charges are not being recorded timely, completely, or accurately. There is a lack of sufficient systems, processes, and data to support reconciliation of buyer-side trading partner information. Accounts payable with the public are not being recorded timely, completely, or accurately in all cases. Some existing procedures create abnormal balances.

**Environmental Liabilities.** Non-Defense Environmental Restoration Program liabilities are not currently being reported and therefore the line is not ready for audit.

**Problem Disbursements.** Inaccurate or missing fund accounting codes have resulted in unmatched disbursements and collections requiring use of suspense accounts. The suspense accounts cause difficulty in reconciling Department of the Navy fund records with Treasury's records.

### **Compliance With Laws and Regulations**

Management is responsible for compliance with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continue to exist. Therefore, we did not determine whether the Department of the Navy was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

**Financial Management Systems.** The Department of the Navy is required to comply with financial management systems reporting requirements. For example, the Federal Financial Management Improvement Act of 1996 requires the Department of the Navy to establish and maintain financial management systems that comply substantially with the Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In addition, the Federal Managers' Financial Integrity Act of 1982 requires the Department of the Navy to evaluate the systems and to annually report whether those systems are in compliance with applicable requirements. The Chief Financial Officers Act of 1990 requires the DoD to prepare a 5-year Financial Management Plan describing activities that DoD will conduct during the next 5 years to improve financial management.

The Department of the Navy acknowledged that many of its critical financial management and feeder systems do not comply substantially with the Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In an attempt to comply with statutory reporting requirements and applicable financial system requirements, DoD is developing a DoD-wide Business Enterprise Architecture. The architecture will provide a blue print of the Department's financial management systems and processes to initiate a comprehensive financial management reform effort. Until the architecture is fully developed, the Department of the Navy will be unable to fully comply with the statutory reporting requirements. Therefore, we did not perform tests of compliance for these requirements.

## **Audit Disclosures**

The Assistant Secretary of the Navy (Financial Management and Comptroller) acknowledged to us on February 18, 2004, that the Navy General Fund financial management systems cannot provide adequate evidence supporting various material amounts on the financial statements. Therefore, we did not conduct audit work related to deficiencies identified during previous audits of the Department of the Navy.

In addition, we did not perform audit work related to the following selected provisions of laws and regulations: the Antideficiency Act, the Prompt Payment Act, and the Federal Credit Reform Act.

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions.